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SLICING THE AMERICAN PIE

How "Standard" Is Standard Economics?

Hyman P. Minsky

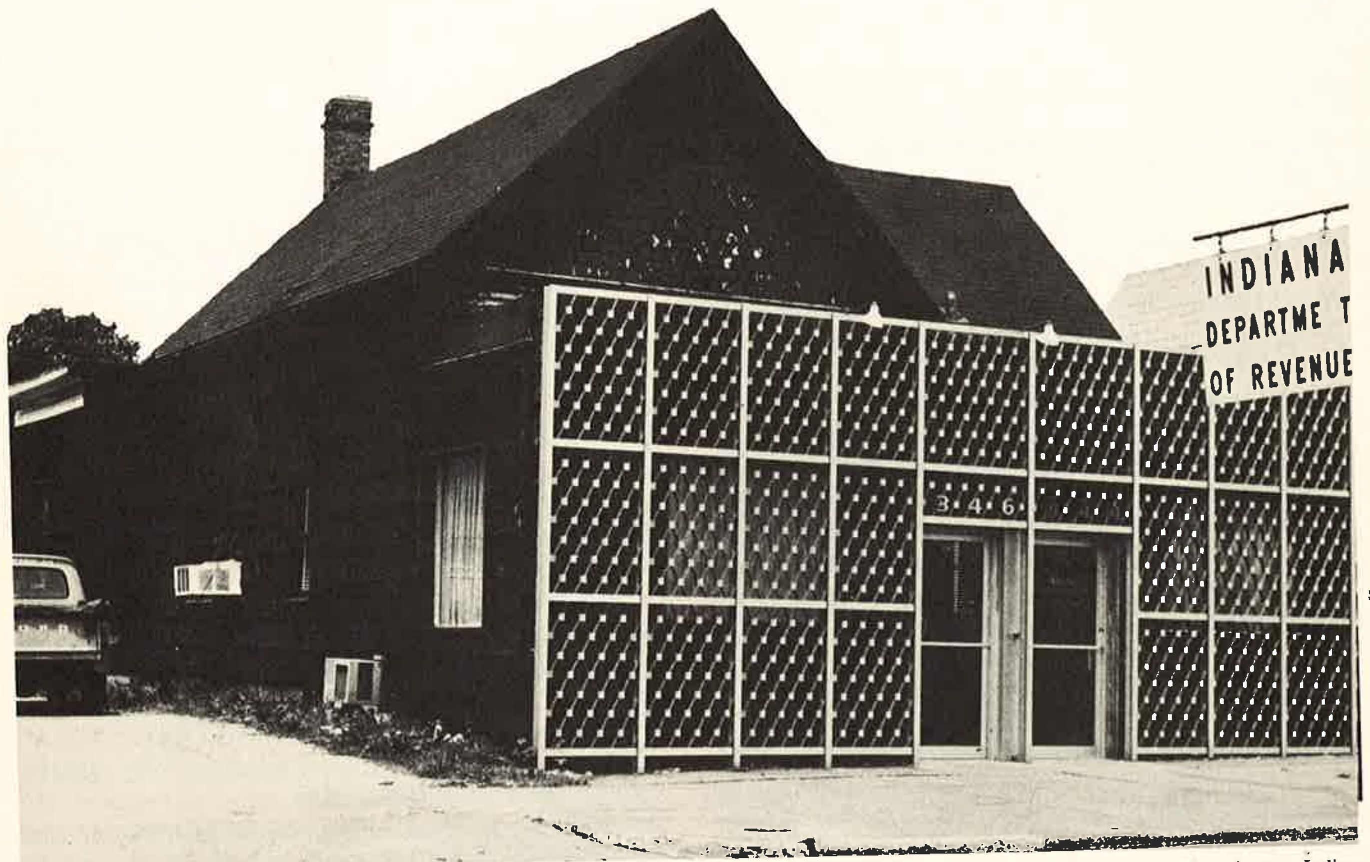

Photo by Harold D. Lasswell

Finance Department, Bloomington, Indiana

The poor performance of economic forecasts and policy since the mid-1960s means that economics as a discipline has a great deal to be modest about. In particular, the credentials of the economists who have been giving policy advice must be questioned.

In 1976 Alan Greenspan, chairman of the Council of Economic Advisors with Presidents Nixon and Ford, guaranteed that unemployment would be at or below 7 percent and falling by year end. The various commercial econometric forecasts—Klein's "Wharton Econometrics," Eckstein's "Data Resources," and Evans's "Chase Econometrics"—were all at least as wrong as Greenspan. They essentially agreed that a 6 percent expansion rate and a 6 percent price rise was in the offing during 1976. Not only did the actual expansion rate in 1976 fall below the forecast rate, but at year end 1976 unemployment was 8 percent.

Crisis in Economic Theory

Greenspan, Klein, Eckstein, and Evans are reputable professional economists and very bright people. They are supported in their activities by a galaxy of well-trained

economists and statisticians. Their forecasts and policy advice are always buttressed by a parade of computer printouts. They impress patrons with their mathematical formulas, wealth of numbers, and academic credentials. Nevertheless, despite their reputations and prestigious positions, their most striking common attribute is that they were wrong in 1976.

Furthermore, this is not the first time they and other establishment economists have been wrong: the years since the mid-1960s are littered with the errors of establishment economists. As a result of the failure of establishment economics, policy decisions have been inept. Wrong and inept policy has led to a marked deterioration in the performance of the economy.

Unfortunately it is the unemployed, the poor, and the near poor—the hourly factory hands—who pay a high price for these failures. Even as they are wrong time and again, these establishment-advising economists become ever more affluent and influential. It is a wry characteristic of our times that as the established forecasting services fall on their faces, their billings continue to rise—and their influence in the corridors of power continues to increase.

In a serious discipline, whenever experimental evidence disagrees with the predictions of a theory, the theory is either discarded or modified. Each economic forecast and each economic policy decision is like an experiment in science which tests a theory. The failure of forecasts and the failure of the economy to react as predicted to policy actions are evidence that the theory underlying the forecasting models and the policy advice do not capture essential characteristics of our economy. There is a crisis in economic theory, for the standard theory that the advisors use seems to be less relevant for our economy with each passing year. The problem of economics is to develop and apply a theory that is relevant for the world in which we live.

Economic theory is a construct of man that is created to explain phenomena in the world. Economic theory—like all scientific disciplines—grows and develops under two types of stimuli, the internal logic of the ruling theory and external worldly pressures. A discipline is in a crisis whenever the inherited body of theory will not do. Economics is now in a crisis and the main task of the discipline is to develop new theory to replace the inherited theory.

Neoclassical System

Much is made in the press and in the discipline about the distinction between monetarists and Keynesians; between the economics and the economic policy advice of Nobel Laureates Milton Friedman and Paul Samuelson; between a chairman of the Council of Economic Advisors like Alan Greenspan and one like Walter Heller. In truth there is no significant difference in the economic theory used by these economists. Monetarists and Keynesians use the same economic theory.

Today's standard economic theory—the theory that underlies the models of both the monetarists and the Keynesians—is usually called the "neoclassical synthesis." This economic theory is largely a creature of the years since World War II. The neoclassical synthesis was born after the appearance of Keynes's classic work on employment, interest, and money, and integrates some aspects of Keynes's thought with the older classical analysis that Keynes believed he was replacing. It is the neoclassical synthesis that has failed.

Standard economic theory becomes less relevant each year.

Keynes's study is a complex work that explores many facets of a capitalist economy. The essential aspect of Keynes's theory is a deep analysis of how financial forces—which we can characterize as Wall Street—interact with production and consumption forces to determine output, employment, and prices. One, but not the most important, result of Keynes's theory is the demonstration that under capitalist institutional arrangements the economy at times will be characterized by persistent unemployment. The neoclassical synthesis seizes upon this result of Keynes's theory. However, the most important result of Keynes's theory is ignored in the neoclassical theory. This most important result is that a capital-using capitalist economy with sophisticated financial practices (i.e., the type of economy we live in) is inherently unstable. It is this second result, and the analysis of the economy by Keynes that led to this result, that provides us the foundation for an alternative to the neoclassical synthesis.

The neoclassical synthesis is derived by integrating the bare bones model derived from Keynes that explains the way in which an economy may generate persistent unemployment with the labor and commodity market model that was developed in the classical economics. The neoclassical synthesis shows that (1) fiscal and monetary policy measures can eliminate persistent unemployment and (2) there are self-correcting forces within decentralized markets that would in time lead to the absorption of unemployment. Thus the neoclassical synthesis speaks with a forked tongue. On the one hand, it holds that activist, interventionist policy can eliminate persistent unemployment or chronic inflation; and on the other, it holds that if nothing is done the economy will in time and of its own workings settle in a stable price, full-employment regime. The same theory can rationalize the noninterventionist views of Alan Greenspan and the interventionist views of Walter Heller.

It is evident that this neoclassical synthesis will not do for our economy in our time. It is designed to deal with equilibrium and equilibrating tendencies, whereas our economy has been increasingly unstable. Three progressively more serious financial trauma, recessions, and critically disruptive movements in interest rates and asset prices have taken place since 1966. Such unstable behavior is foreign to the neoclassical synthesis. Standard economists can offer no satisfactory explanation of what happened in the past decade. The least we can require of economic theory is an explanation of why a financial debacle almost occurred in 1974–75.

Inept policy causes deterioration in the economy.

In order to do better, economists must abandon standard theory and develop an alternative line of thought that pays attention to the institutional detail and disequilibrating relations of our economy. Such an alternative is emerging in what is now called "post-Keynesian" theory. The particular version of post-Keynesian theory that will be taken up here emphasizes the financial relations of a capitalist economy. This post-Keynesian theory shows that strong endogenous destabilizing processes exist in an economy that is capitalist, uses capital-intensive production techniques, and is financially sophisticated. Our type of economy is inherently unstable.

Institutional Characteristics of Capitalism

Adam Smith, the founder of economic theory, posed two questions. How come a decentralized market economy does not result in chaos, i.e., is coherent? How come one country is richer or poorer than another? The neoclassical synthesis has grown out of the attempt to answer the first question. Marxist economics and the economic theory derived from Keynes that is relevant for our times are mainly concerned with Smith's second question.

Standard economic theory has shown that a decentralized market mechanism will yield a coherent result with respect to the details of production, consumption, and income distribution under a wide variety of market structures (oligopoly, monopoly, and competitive markets) and a wide variety of institutions (trade unions, corporations, public ownership). The robustness of the coherence of decentralized markets means that the outcomes may be inefficient and inequitable. A coherent economy need not be a just economy.

Although the standard economic theory of Keynes's day could explain why decentralized markets yield a coherent result—albeit not as elegantly as today's mathematized economic theory—it could not explain the persistence of unemployment and it especially could not explain the incoherence financial markets and the economy in general exhibited in 1929–33. Keynes's great work was an attempt to construct an economic theory which can explain why a decentralized market economy is usually coherent but from time to time becomes incoherent. The key to incoherence—the essential flaw in capitalism which makes laissez faire capitalism a system that cannot work—centers in the investment process in a capitalist environment and the way in which both investment activity and ownership of the stock of capital assets are financed. The flaw in capitalism is due to the essential attribute of capitalism: private ownership of the means of production; trading in capital assets and financial assets; and a complex, sophisticated financial system.

A capitalist economy has two institutional characteristics that are critical to the occasional development of incoherence. One is that there are two sets of prices and two sets of transactions. One set of prices and transactions deals with the production and distribution of current output. This set of prices is the only set of prices considered in the classical economics and the neoclassical synthesis. The other set of prices and transactions deals with capital assets and financial instruments.

For the economy to function normally the two sets of prices must be properly aligned because investment, a part of current output, becomes a capital asset once it is produced and at work. Investment goods will not be produced and financed unless it is expected that the price of the finished product as a capital asset will exceed, by a large enough margin of safety to placate the fears of the unknown future, the cost of the investment good. If the prices of capital assets and financial instruments are high relative to current output, then an investment boom and inflation are likely to result; if capital asset and financial instrument prices are low relative to current output prices, then investment will be sluggish. A recession is likely to occur.

Another institutional characteristic of the economy we are concerned with is that there is a system of borrowing and lending based upon margins of safety. The essential borrowing and lending in a capitalist economy finances investment and positions in the stock of capital assets. Furthermore, the money supply of a capitalist economy emerges out of the borrowing and lending that takes place. Borrowing and lending are always money today-money tomorrow exchanges; because of the nature of time and history, the future is always uncertain. Thus the extent and the nature of the margins of safety required by both the borrower and the lender, as they enter into deals, will depend upon the views of the future.

Over a run of good times the view as to the required margins of safety needed for various debts decreases. Furthermore, the practice of borrowing with the expectation that the debt will be repaid by issuing new debt increases. In addition, idle cash is activated as good times are sustained. The essential instability of capitalism centers around the way in which financial margins of safety are eroded during periods of good times. As the margins of safety are eroded, the price of capital assets rises relatively to the price of current output. The economy will generate an inflationary boom out of its internal operations. However, because some of the financing of this boom comes from activating the cash that is

held as a margin of safety, an inflationary boom will be accompanied by a rise in interest rates.

This argument is an expansion and extension of ideas and concepts that are in Keynes's work but which are largely neglected in the development of today's standard economics. Financial instability as the result of the internal workings of the economy is foreign to the economics of the neoclassical synthesis. Whether an economist be labeled Keynesian or monetarist, liberal or conservative, Republican or Democrat, as long as his economic theory is the standard theory of today he has no way of explaining the credit crunch of 1966, the commercial paper crisis of 1970, and the multidimensional financial trauma of 1974–75.

The neoclassical synthesis is thus a theory that does well enough in explaining the behavior of our economy in an age of financial tranquility such as ruled in the period immediately after World War II. But it cannot provide a relevant framework for our type of economy in the past decade.

Recent Economic Incoherence

In the autumn of 1966 a near miss with respect to a financial crisis took place. This so-called credit crunch was the first event of its kind since the era of the Great Depression. In 1970, in the aftermath of the failure of the Penn Central Railroad, another near financial crisis occurred. In 1974–75 there was a spate of bank failures—including the failure of the $5 billion Franklin National Bank—and a virtual bankruptcy of the entire real estate investment trust industry (REIT). These three financial crises were resolved by means of extraordinary actions by the Federal Reserve System; these extraordinary actions were the lender-of-last-resort intervention by the Federal Reserve.

A financial crisis takes place when a run occurs on a set of financial institutions or markets. These financial institutions and markets have short-term debts outstanding, and they use this short-term debt to finance positions in longer-term assets. The short-term financing of holdings of long-term assets is the essence of speculative finance. Both the unit engaging in speculative finance and its lender expect new debt to be issued to repay maturing debt; debt is expect to be "rolled over." The continued viability of a unit engaged in speculative finance depends upon the normal functioning of those financial markets in which its debt will be rolled over. The normal functioning of a financial market can be disrupted by any event which makes the suppliers of funds to these markets suspect that the funds they place in this market or instrument may either be lost through default or that payment may be stretched out. Periodic runs on banks and financial markets are normal results of financial practices in a capital-using economy.

The credit crunch of 1966 was the first financial difficulty since the 1930s that involved a run on a financial instrument or set of institutions and which required special Federal Reserve action. The credit crunch of 1966 was a normal outgrowth of the uninterrupted expansion of the economy since early 1961 in the context of a longer postwar period in which there was no significant recession. Under capitalism a protracted period of good times leads first to a boom and then to a crisis.

The second postwar financial disturbance that required Federal Reserve lender-of-last-resort intervention occurred in 1970. This time the market in distress was the commercial paper market, and the Federal Reserve's intervention took the form of allowing banks to acquire funds from the Federal Reserve so that a run on commercial paper could be refinanced.

Giant banks and financial markets must be controlled.

The most serious financial crisis, the highest unemployment, and the deepest recession since World War II took place in 1974–75. This situation followed fast upon the highest interest rates in modern times. Only decisive lender-of-last-resort actions by the Federal Reserve and cooperating commercial banks, together with the income- and financial-stabilizing effects of big government, prevented the bad of 1975 and 1976 from being worse. The steps taken to avert the worst that could have happened planted "time bombs" in the economy that have been going off since 1976, and which threaten an even worse financial crisis in the near future.

1974–75 Financial Traumas

The 1966 and 1970 episodes followed a fight against inflation by the Federal Reserve, a fight that took the form of imposing monetary constraint. Following the 1966 episode a pause in the economic expansion took place; after 1970 a recession occurred. Inflation was at a higher rate after 1966 than before. After 1970 the United States experienced double-digit inflation.

In the world inhabited by establishment economists and the Federal Reserve, nothing succeeds like failure. The failure of monetary constraint to achieve more than transitory success in halting inflation in 1966 and 1970 and the success of monetary constraint in triggering financial traumas that threatened a deep depression in these years meant that monetary constraint was sure to be the principal weapon of an antiinflationary policy in 1973–74.

The critical element in the multifaceted financial crisis of 1974–75 was the failure in October 1974 of Franklin National Bank. At the end of 1973 Franklin National, with $5 billion in total assets, was the twentieth largest bank in the United States. It was by far the largest U.S. bank that has ever failed, and its failure may be a sign of what awaits us.

The failure of Franklin National was triggered by a run on its London branch and Wall Street operations after losses in its foreign exchange operations were disclosed. When Franklin National was finally closed, some $1.7 of its $3.6 billion in assets were supported by Federal Reserve loans. As a result of this massive infusion of funds by the Federal Reserve, all the deposit liabilities of Franklin National Bank, including certificates of deposit at the overseas branch, were validated. By its action in 1974 the Federal Reserve extended the protection of the Federal Reserve system to deposits at overseas branches of U.S. banks. By furnishing Franklin National with funds to pay off its overseas depositors, the Federal Reserve was in effect making every dollar of deposits at an overseas branch of a U.S. chartered bank the equivalent of a deposit in a U.S. bank. Thus in 1974 the Federal Reserve abdicated its responsibility for controlling the growth of the U.S. money supply.

Current economic advisors' credentials must be questioned.

The Franklin National failure was not the only dimension of the financial crisis of 1974. An entire financial industry, the real estate investment trusts, lost is ability to sell its commercial paper in the market. The run on the REIT commercial paper was offset by a huge infusion of bank credit in order to prevent wholesale bankruptcy. The earnings and net worth of many giant and large commercial banks were impaired by this refinancing operation. In addition to failures of Franklin National and other large banks and the run on the REITs, 1974–75 also saw the near bankruptcy of New York City, a number of utility companies, and some major airlines. "Debt restructuring" and walking bankruptcies characterized these years.

Lessons from the Runs

These three serious runs occurred on financial markets or banks. The 1966 run occurred on bank certificates of deposit; the 1970 run occurred on the commercial paper market; and the 1974–75 run occurred on two fronts, the commercial paper of REITs and the money market deposits of Franklin National. Each time a run occurred an instrument or an institution that had grown rapidly during the preceding boom was the focal point of the disturbance; each time a run occurred the Federal Reserve intervened to facilitate the refinancing of the threatened position.

Thus by its protection the Federal Reserve legitimized the new instrument or the new institution. In 1966 and 1970 minor institutional and usage reforms were ventured after the near crisis. No serious effort at reform of the overseas operations of U.S. banks occurred after the 1974 Franklin National fiasco.

The growth and history of certificates of deposits, commercial paper and the accompanying covert bank liabilities, and the liabilities of overseas branches of U.S. banks show that the elaborate mechanisms of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the comptroller of the currency are not capable of controlling the disruptive and destablizing behavior of the giant banks. Because present policymakers wear blinders due to their acceptance of neoclassical theory, which does not allow for financial instability, they cannot visualize the reform of banking and finance that is needed if a more stable, more nearly fully employed, and less inflationary economy is to be achieved.

Proposals for Reform

Giant banks and multibillion dollar financial markets outside of banks must be brought under control. As things now stand the Federal Reserve and the other authorities are periodically confronted with a decision: do they validate and protect the positions of the giant banks, or do they allow a giant, worldwide depression to occur? When faced with these alternatives, the choice of the banking authorities and the political leadership is preordained: they will do all they can to bail out the financial markets and institutions that are threatened. The process of the bailout assures that another inflationary round followed by another crisis will occur unless, in the interval after the bailout, serious reforms of the financial structure are undertaken.

Because the standard economic theory of our day cannot explain financial crises, to the economist-advisor they do not exist. The inflation/threat of crisis oscillations are explained by errors in the manipulation of the money supply and in fiscal variables. The transition period to the Carter administration was evidence of the superficial nature of the current political discourse. The questions that were debated related to the size and presumed beneficiaries of a tax cut and whether the money supply, whatever that may be, should grow at one rate or another. No question was asked about why our economy has become a chronic labor surplus economy and why our economy is so given to fluctuations.

Post-Keynesian theory of the kind that is emerging as an alternative to the neoclassical synthesis leads to two propositions that should guide reform and reconstruction of our economy. The first is that decentralized markets lead to a coherent result; the second is that the financial institutions of capitalism are fundamentally destabilizing. The first proposition implies that detailed planning is not necessary and that the market mechanism, because it leads to a coherent but in no sense a best result, can and should be used as an instrument for achieving social objectives. The second proposition implies that if strongly disruptive business cycles are to be avoided, the banking and financial system must be constrained and controlled as well as protected by the Federal Reserve.

Currently the Federal Reserve System has no effective control and has no means of constraining the giant money market banks. There are some nine banks in the United States—six in New York City, two in Chicago, and one in California—which operate large-scale overseas branch systems, which have total assets in excess of $20 billion each, and which have huge trust and other specialized money management operations. These giant banks also have a very thin owners equity/total assets ratio.

To construct a financial system that is more conducive to stability, it is necessary to bring these giant banks under control. The only way this control can be achieved is by reducing their size to manageable proportions. The rule of thumb is that no bank or financial institution can be so big that the Federal Reserve would not allow the institution to fail. Thus no institution can be so big that its failure is likely to trigger a debt deflation process which leads to a big depression.

To bring the giant banks under control, it is necessary to separate the three functions—domestic banking, overseas banking, and trust activities—into separate organizations. When this move is attempted the glaring weakness of the capital position of the giant banks will be revealed. In addition, the giant banks should be broken into manageable pieces. The first step in doing this is to separate the domestic banking, overseas banking, trust operations, and nonbanking financial businesses of banks into different organizations. The second step in creating banks of manageable size is to separate the wholesale, money market business of these giant banks from their retail financing of modest-sized business activities. A third step in breaking up the giant banks would be to separate the various banking parts into units in the $5 billion class.

Further, the smaller banks should be unleashed and put on even terms with the giant banks. As things now stand the smaller banks—those with between $50 million and $1 billion in total assets—are more highly constrained than the big banks. The regulatory authorities do enforce a capital/asset ratio in the neighborhood of 8 percent for these banks. They should be allowed to lower their capital/asset ratio to the same 6 percent ratio that will be imposed upon the giant banks. As a result of this lowering of their capital/asset ratios, the profitability of smaller banks will increase.

Another needed reform is to remove the prohibition against merchant or investment banking from these smaller banks. This prohibition was based upon the misuse of power by the giant Wall Street banks in the 1920s and real ignorance of the comprehensive financing role that small bankers play on Main Street. Any program designed to make market capitalism work by structuring financial markets in favor of smaller-sized firms must come to grips with the barrier to the adequate financing of smaller units that results from the prohibition of investment-banking activities by smaller banks.

No system of structural institutional reform can promise eternal bliss; in an evolutionary environment such as an economy all reform can do is promise better. The fiscal policy proposals that followed from the standard reading of Keynes did give us twenty to thirty years in which we had a closer approximation to full employment than hitherto. During this period of relative tranquility destabilizing forces which are always characteristic of capitalism gained weight in the financial sector. It is now quite clear that without substantial reform of the banking and financial system, the degree of approximation to full employment achieved in the first postwar era will not be attainable.

Stabilizing the Economy

Whereas the events of 1966, 1970, and 1974–75 are anomalies from the viewpoint of the neoclassical synthesis, they are normal events within the alternative theory based upon Keynes's analysis of our type of economy. In the Keynesian theory it is to be expected that tranquil good times will lead to a boom that will lead to ever increasing ratios of speculative financial relations. This pattern will continue until the rising financial commitments, made worse by rising interest rates, cannot be sustained by the underlying income-generating process. At that time a break will occur, and with the break will come a threat of a deep depression.

The combination of lender-of-last-resort action by the Federal Reserve and the impact of big government meant that a big depression did not occur following the crises of the sixties and seventies. In order to prevent the future from being characterized by accelerating inflation and deepening recessions, the disruptive influences of finance—and in particular the giant banks—must be reduced. The only way in which this end can be achieved is by breaking up the present giant banks into units of controllable size.

Dissolving the giant banks is not a solution of the economic problems for all time; deeper structural reforms that eliminate the dependence of the economy upon giant capital-intensive corporations are also needed. But because of the existing unstable international financial system that has developed since the Federal Reserve accepted responsibility without power after the Franklin National Bank fiasco, there is an urgency to the need to understand how finance and instability are related so that more effective control of destabilizing forces can be achieved.☐

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